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IN THE

Supreme Court of the United States

October Term, 1955

No. 639

FORREST L. MOE and EDITH B. MOE, *Petitioners,*

v.

HUGH H. EARLE, former Collector of Internal Revenue at Portland, Oregon.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Forrest L. Moe and Edith B. Moe, your petitioners, pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit, entered in the above-entitled case on October 28, 1955.

OPINIONS BELOW

The oral opinion of the District Court (Appendix A) is unreported. The opinion of the Court of Appeals (Appendix B) is reported at 226 F. 2d 583.

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JURISDICTION

The judgment of the Court of Appeals was entered on October 28, 1955 (Appendix C). The jurisdiction of this Court is invoked under the provisions of 28 U.S.C., Sec. 1254(1).

QUESTION PRESENTED

Whether sums deducted and retained for capital purposes by a tax-exempt farmer cooperative marketing association out of net sales proceeds which it is legally obligated to pay to its member patrons, and set off by the cooperative in satisfaction of such patrons' legal obligation to contribute to the capital of the cooperative, constitute taxable income, in any amount, to such patrons who file their income tax returns on a cash receipts and disbursements basis, (1) in the tax year during which the sums originally are retained by the cooperative as a set off, with corresponding credit to the patrons as capital contributions, (or in a later tax year during which non-negotiable, non-interest bearing certificates evidencing such capital credits are physically issued to the patrons) or (2) in a subsequent tax year during which such capital credits are redeemed by payment by the cooperative to the patrons in cash. That such amounts are taxable income to the patron at some time is recognized by all parties. The question is in what year and in what amount.

STATUTES INVOLVED

Sections 22 and 42 of the Revenue Act of 1928, (C. 852, 45 Stat. 791-883); Revenue Act of 1934, (C. 277, 48 Stat. 680-772); Revenue Act of 1936 (C. 690, 49 Stat. 1648-1756); and Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.)

SEC. 22. GROSS INCOME.

(a) *General Definition.*— "Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income from any source whatever. * * *

* * * * * * * * *

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

* * * * * * * * *

1951 AMENDMENT

The Revenue Act of 1951, 65 Stat. 452, included amendments to the tax treatment of farmer cooperatives. Although that amendment did not become effective until after the years involved in the present case, its provisions are relevant in considering the reasons for issuance of the writ. It is therefore reproduced here as follows:

SEC. 314. INCOME TAX TREATMENT OF EXEMPT COOPERATIVES.

(a) Amendment of section 101 (12). Section 101 (12) is hereby amended as follows:

(1) By inserting after "(12)" the following: "(A)"

(2) By inserting after such paragraph the following:

(B) An organization exempt from taxation under the provisions of subparagraph (A) shall be subject to the taxes imposed by sections 13 and 15, or section 117 (c) (1), except that in computing the net income of such an organization there shall be allowed as deductions from gross income (in addition to other deductions allowable under section 23)—

(i) Amounts paid as dividends during the taxable year upon its capital stock, and

(ii) Amounts allocated during the taxable year to patrons with respect to its income not derived from patronage (whether or not such income was derived during such taxable year) whether paid in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some manner that discloses to each patron the dollar amount allocated to him. Allocations made after the close of the taxable year and on or before the fifteenth day of the ninth month following the close of such year shall be considered as made on the last day of such taxable year to the extent the allocations are attributable to income derived before the close of such year.

Patronage dividends, refunds, and rebates to patrons with respect to their patronage in the same or preceding years (whether paid in cash, merchandise, capital stock, revolving fund certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount of such dividend, refund or rebate) shall be

taken into account in computing net income in the same manner as in the case of a cooperative organization not exempt under subparagraph (a). Such dividends, refunds, and rebates made after the close of the taxable year and on or before the 15th day of the ninth month following the close of such year shall be considered as made on the last day of such taxable year to the extent the dividends, refunds, or rebates, are attributable to patronage occurring before the close of such year.

(b) Technical amendments.—

(1) Section 101 is hereby amended by striking out "Except as provided in supplement U" and inserting in lieu thereof the following: "Except as provided in paragraph (12) (B) and in supplement U".

(2) The last sentence of section 101 is hereby amended by striking out "Notwithstanding supplement U" and inserting in lieu thereof "Notwithstanding paragraph (12) (B) and supplement U".

* * * * * * * * *

(d) Effective date.—The amendments made by subsections (a) and (b) of this section shall be applicable only with respect to taxable years beginning after December 31, 1951. * * * (65 Stat. 491-93)

REGULATIONS

Pertinent regulations are as follows:

Regulations 118-39.22(a)-13 *Cancellation of Indebtedness.*

Paragraph from Instructions accompanying Form 1040 for 1948.

Income Tax Information Release No. 2, April 13, 1950, *Patronage Dividends.*

Regulations 118-39.22(a)-23 *Allocations by cooperative associations; tax treatment as to patrons.*

Revenue Ruling 54-10, *Allocations of cooperative associations and tax treatment as to patrons of amounts distributed in document form.*

Pertinent text of the foregoing regulations is contained in Appendix E.

STATEMENT

Petitioners are fruit growers in the Hood River Valley of Oregon. They have been members and patrons since 1929 of the Apple Growers Association, a corporation operating as a nonprofit farmers' cooperative marketing association exempt from corporation income tax under Section 101 (12) of the Internal Revenue Code (R. 55, 56).[1]

The Standard Cooperative Growers Contract between the cooperative and petitioners (set forth in full in Appendix D) provides that the fruit delivered to the cooperative each year by petitioners shall be pooled with fruit delivered by other growers, and that the cooperative shall pay to petitioners their prorata share of the net sales proceeds of the pooled fruit within thirty days after the cooperative's receipt of the money for that pool (R. 55, 56, 96).

A bylaw of the cooperative in effect when petitioners became members and until 1940, provided for a permanent "Building and Equipment Fund" to be developed and maintained through a charge by the cooperative against each patron based upon the amount of fruit handled by the cooperative for that patron,

[1] Recodified by Internal Revenue Code of 1954 as Section 521.

and to be used exclusively for "the purchase of or paying for property, equipment or betterments" (R. 56-57, 113).

Such Building and Equipment Fund charge was deducted each year by the cooperative from petitioners' shares of the net proceeds of that year's pools, and was balanced by a corresponding credit on petitioners' capital ledger account with the cooperative (Pet. Ex. 3, 4, 5, 6, 33; R. 57-59, 128-131). The amount due petitioners as additional proceeds was thus set off against petitioners' obligation to contribute such amount as capital. Timely annual accounting was rendered by the cooperative to petitioners for the fruit delivered by them, and the balance of their share of the net proceeds of each pool after deduction of the Building and Equipment Fund charges was paid to petitioners each year in cash (R. 58-59, 98-99, 125-131).

The sums thus charged and credited to petitioners as their contributions to the Building and Equipment Fund during the years here involved are as follows (R. 59-60):

Year	Amount
1930	$140.46
1931	$261.48
1935	$ 78.76
1936	$116.99
1937	$100.25

Until 1940, there was no provision in the cooperative's bylaws for, and the cooperative did not issue, any kind of certificate evidencing such capital contributions. In that year, the bylaws were amended to make the Building and Equipment Fund a part of a "revolving capital fund", and provision was

included for the issuance of a "certificate" each year to each member of the cooperative showing the amount of that member's contribution during the year to the revolving capital fund. This bylaw amendment is set forth in full in the Record, pp. 60-65.

Pursuant to the 1940 bylaw amendment, the cooperative in 1942 issued and delivered to petitioners five documents entitled "certificate of contribution to revolving capital fund", specifying the amount contributed by petitioners to the Building and Equipment Fund during each of the five years 1930, 1931, 1935, 1936 and 1937 (R. 65). Each certificate included on its face the following:

> "This is to Certify that during the fiscal year beginning June 1, ——, contributions totaling ——— were made to said fund by the above-named member or his predecessor. Upon surrender of this certificate the contributor or rightful assignee will be entitled to a refund of his pro rata share thereof with all other contributors for said year, subject to all provisions of members by-laws of the Association, when and if the Board of Directors shall determine to refund same.
>
> "This certificate does not represent any debt owing by the Association, shall not bear interest, gives no voting rights, becomes null and void after the membership under which said contributions were made shall be by any owner thereof cancelled, terminated or forfeited, shall not be negotiable or assignable except to the purchaser of the membership under which contributions were made and the premises to which same pertains, and then only by consent of the Board of Directors of said Association and also, subject to any unpaid debt or obligation of the assignor to the Association to be assumed by such accepted assignee.

> "The time and amount of any refund upon this certificate is and shall be within the discretion of the Board of Directors of Apple Growers Association and the rights hereunder are and will be governed by the members' by-laws of said Association and the holder hereof will and does accept same subject to those conditions and with that knowledge." (Pet. Ex. 8, 9, 10, 11, 12).

Issuance of certificates after the first issue in 1942 was kept current with the calendar year of the contributions represented (R. 116).

Petitioners did not file income tax returns for any of the five years prior to 1942 during which the Building and Equipment Fund credits here involved were accumulated (R. 69). Petitioners did file their timely joint return for the year 1942, on a cash-receipts basis, but did not include therein any sum represented by the certificates issued to them in that year (R. 67, 99-101).

In 1949 the cooperative, in "revolving" the Building and Equipment Fund portion of its revolving capital fund as provided by the 1940 bylaw, paid to petitioners in cash the $401.94 which had been credited to them for the Building and Equipment Fund during 1930 and 1931 and which was represented by certificates issued in 1942 (R. 66). Petitioners also received from the cooperative during 1949 a certificate of contribution to revolving capital fund evidencing $986.18 which petitioners had contributed to the revolving capital fund through deductions from net sales proceeds during the 1948-1949 fiscal year set off against their capital obligation (R. 67).

In their joint income tax return for the calendar year 1949 (Pet. Ex. 26), petitioners included the cash received by them during that year in redemption of

the revolving fund certificates for 1930 and 1931, but not for the amount represented by the certificate of contribution issued to them in that year nor any part thereof (R. 66-67, 106-107).

Following a ruling by the Bureau of Internal Revenue released April 13, 1950 (Pet. Ex. 38; R. 107) that cooperative association patrons must include in their gross income for tax purposes the face amounts of cooperative revolving fund certificates as well as cash distributions, petitioners' 1949 return was audited and a deficiency was assessed to the extent of the face amount of the omitted 1949 certificate, and the consequent additional tax was paid by petitioners (R. 67).[2]

In 1951, petitioners received from the cooperative cash refunds of their contributions to the Building and Equipment Fund during the years 1934, 1935 and 1936 represented by certificates issued in 1942 (R. 68-69). Petitioners also received in 1951 a certificate evidencing their payments to the revolving capital fund during 1951 (R. 107). Their joint 1951 cash-basis tax return included the cash refund of the 1935, 1936 and 1937 Building and Equipment Fund contributions, and also the face amount of the certificate issued in 1951 (Pet. Ex. 28; R. 107).[3]

Timely refund claims thereafter were filed by petitioners covering the taxes paid by them for 1949 and

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[2] See Note 3, *infra*.

[3] Payment of the 1949 and 1951 taxes on the face amounts of the 1949 and 1951 certificates was entirely consistent with petitioners' contention that the tax accrues only in the year the capital contribution is made, inasmuch as the sums evidenced by those certificates had in fact been contributed as capital during the same tax years in which the certificates were issued (R. 116).

1951 on the cash payments received by them during those years of the amounts in redemption of their capital contributions to the cooperative's Building and Equipment Fund, on the ground that such cash receipts were not income to the taxpayers in 1949 and 1951 (Pet. Ex. 29, 30). Suit for the claimed refunds was then prosecuted in the United States District Court for Oregon on the jurisdictional basis of 28 U.S.C., Sec. 1340.

Petitioners contended in the trial court that the cooperative's capital fund charges against the net sales proceeds payable to petitioners constituted income received by petitioners in the years in which the cooperative's charges against them for its Building and Equipment Fund were deducted from the net proceeds of the cooperative's sales of their fruit and credited to their capital account; that the later issue, in 1942, of certificates of contribution was of no significance for tax purposes; and that the cash refunds to them in 1949 and 1951 in redemption of their 1930-1936 capital contributions constituted a return to them of capital, and not taxable income.

The government contended that the certificates issued in 1942 constituted patronage dividends paid in non-cash form and hence were taxable in 1942; that in failing to include the certificates in their 1942 tax return, petitioners established a zero-value tax basis for the 1942 certificates, so that the full cash payment received in 1949 and 1951 in "redemption" of 1942 certificates constituted ordinary income in 1949 and 1951.

The District Court, sitting without a jury, rendered an oral opinion (App. A.), but no written opinion was filed. The Court's findings of fact and conclusions of law appear on pages 54-71 of the Record.

The trial court agreed with petitioners that the 1942 issuance to them of the certificates of contribution did not constitute or represent taxable income to petitioners in 1942. The court further concluded, however, that taxable income was received by petitioners in the years 1949 and 1951 when they received the cash refunds, and that no taxable income was received in the earlier years when the money originally was deducted from the petitioners' sales proceeds and set-off against their capital obligation. (R. 53, 70-71). Judgment accordingly was entered dismissing petitioners' complaint (R. 72-73).

This was affirmed by the Court of Appeals below (C.A. Op., App. B.; C.A. Judgment, App. C).

REASONS FOR GRANTING THE WRIT

In affirming the District Court's decision that petitioners received taxable income only when their capital contributions were refunded to them in cash, the Court of Appeals decided an important question of Federal Tax Law which never has been, but should be, decided by this Court. The decision is also in conflict with decisions of other circuits, in conflict with decisions of the same circuit and other courts involving tax treatment of farmer cooperatives, in conflict with long standing practice of the Internal Revenue Bureau, and in conflict with the Congressional intent exhibited in the enactment of Section 314 of the Revenue Act of 1951. Only a decision by this Court will resolve the existing confusion and enable hundreds of thousands of farmers to know how to file a correct tax return.

CONFLICT

Between Circuit Decisions

In the *per curiam* decision of the instant case, the Court of Appeals refers to its decision in the case of *Caswell's Estate* v. *Commissioner,* (9th Cir. 1954) 211 F. 2nd 693 for a statement of the principles upon which the instant decision is based. The decision also cites *Commissioner* v. *Carpenter,* (5th Cir. 1955) 219 F. 2nd 635. Although both of these decisions reached the same result, namely that the taxpayer patron was not taxable, the decisions are in sharp conflict.

In the *Carpenter* case the Court held that the cooperative patron was taxable upon the fair market value of the certificate there received; but in that particular case such fair market value was found to be zero. In the *Caswell* case, the Court disregarded the finding of the Tax Court that the certificates there received had a fair market value equal to the face value (17 TC 1190 at 1197). Without even mentioning the subject of fair market value, the Court held the certificates not taxable because they gave the taxpayer patron no rights which he did not already have under the by-laws and contract of the cooperative association.

Thus the Fifth Circuit would establish the rule that cooperative patrons are taxable, to the extent of the fair market value thereof, upon certificates issued to them in the distribution of proceeds of sale. The rule established by the Ninth Circuit would be that cooperative patrons are not taxable in any amount, upon certificates issued to them in distribution of proceeds of sale, regardless of the fair market value of such certificates. These rules are wholly inconsistent and no taxpayer can follow both in filing tax returns.

With Decisions Relating to Taxability of Cooperative Associations

Both the Courts of Appeals and the Tax Court have uniformly held that cooperative associations are not taxable upon amounts similar to those involved in the cases just discussed. The basis for such holding is that the cooperative association is obligated to distribute the proceeds of sale to the patrons and that the amounts withheld and set off against the capital contributions for which certificates are issued are not taxable to the cooperative because they do not belong to the cooperative but belong to the patrons. One such decision is that of the Court of Appeals for the 9th Circuit in *San Joaquin Valley Poultry Producers Association* v. *Commissioner,* (9th Cir. 1943) 136 F. 2d, 382. In that case the Court's opinion said:

> "The sums so placed in these reserves ... never became the property of petitioner, but were and are the property of the members. ... To hold otherwise would be to hold the petitioner could and did 'make a profit for itself, as such', in contravention of its by-laws, its articles of incorporation and the statute to which it owes its existence. ...
>
> "Petitioner never pretended to be the owner of these sums, but, as required by its by-laws, 'prorated' and credited them to its members. The fact that the sums were not payable to the members on demand, or at any fixed time, does not alter the fact that they were their property and not petitioner's. Petitioner held them, not as owner, but as agent or trustee for the members ... Since none of the sums ever belonged to petitioner, they could not be, and were not, income of petitioner" (p. 385).

In the foregoing case the Court did not refer to the effect upon the patron's income of the transactions under discussion. However, from the Court's findings that these sums belonged to the members and were held by the cooperative as agent or trustee for the members, it follows that if they were applied to the member's contractual obligation to contribute capital, such application or setoff would be the equivalent of a payment in cash to the member and a payment by him of his obligation to the cooperative.

In *United Cooperatives, Inc.* 4 TC 93 (1944) the Tax Court had under consideration a similar situation with respect to a purchasing cooperative. It was there held that patronage distributions applied to the patron's obligation to purchase the cooperative's stock did not constitute income to the cooperative. The Court said:

> "... The result of the procedure set up by petitioner's by-laws was as if the stockholder member who was under obligation to purchase additional stock had received, in cash, the 'patronage dividend' and had thereupon applied this sum to the payment of his stock. The stock, when thus paid and issued to him, ... represented an additional investment on his part to the capital of the corporation out of his savings from the annual transactions with petitioner"

Other cases supporting the principle that cooperative distributions which the cooperative is obligated to make to its patrons, are not taxable income to it, include *Colony Farms Cooperative Dairy, Inc.,* 17 TC 688 (1951); *Dr. P. Phillips Cooperative,* 17 TC 1002 (1951); *Farmers' Cooperative Co.* v. *Birmingham* (D. Ct. W.D., Iowa—1949) 86 F. Supp. 201. Similar conclusions were reached with respect to ordinary business corporations operating under contracts to refund

or rebate to members in *Uniform Printing and Supply Company* v. *Commissioner,* (7th Cir. 1937) 88 F. 2d 75 and *Paducah and Illinois Railroad Company,* (1925) 2 BTA 1001.

With Internal Revenue Practice

A long established rule in the administration of the Internal Revenue laws is that payment of an obligation by a third person or discharge of a debt by the creditor constitutes income to the obligor or debtor. Regulations issued as interpretations of Section 22 of the Internal Revenue Code (1939) so provide and have been uniformly followed. (Reg. 118-39.22-(a) 13, App. E).

Such a rule has been uniformly followed by decisions of this Court. In *Old Colony Trust Company* v. *Commissioner,* 279 U.S. 716, in holding that an employee must report as income the income taxes paid for him to the government by his employer, the Court said:

> "* * * The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed * * *. The taxes were paid upon a valuable consideration, namely, the services rendered by the employee and as a part of the compensation therefor. We think therefore that the payment constituted income to the employee". (p. 729)

In *Douglas* v. *Willcuts,* 296 U.S. 1, holding income from a trust used to pay alimony was in discharge of an obligation of the husband and therefore income to him, the Court said:

> "* * * We have held that income was received by a taxpayer, when, pursuant to a contract, a debt or other obligation was discharged by an-

> other for his benefit. The transaction was regarded as being the same in substance as if the money had been paid to the taxpayer and he had transmitted it to his creditor". (p. 9)

Here the Cooperative Association owed to the patron proceeds of sale. The Association applied such proceeds to the payment of the patron's obligation to the Association to contribute capital. The discharge of that obligation therefore constituted income to the patron in the amount of the obligation so discharged.

The decision in both the *Caswell* and *Carpenter* cases are in conflict with this well established rule.

The regulations issued by the Treasury interpreting Section 22 did not specifically refer to cooperatives or cooperative patrons. No such specific regulation was promulgated until after the Revenue Act of 1951, when Reg. 118-39.22 (a)-23 was issued (See App. E). That regulation specifically provides that the patron shall be taxable on income to the extent of the face amount of any certificate or similar document received if the allocation was made in fulfillment and satisfaction of a valid pre-existing obligation of such association to the patron. While this particular regulation was issued after the events in the instant case occurred, it describes the practice followed by Internal Revenue in prior years. This is shown by instructions accompanying income tax forms for 1948 and Information Release No. 2 issued in 1950 (App. E).

In its brief in the Court of Appeals, the Government agreed that both the *Caswell* and *Carpenter* decisions were "contrary to long established administrative practice of the Internal Revenue Service" and "inconsistent with the reasoning of certain prior de-

cisions of this and other courts relating to the exemption of certain cooperatives from income tax or to the exclusion of patronage refunds from their income."

With Congressional Intent Exhibited in Enactment of 1951 Amendment

Cooperative taxation was the subject of considerable discussion and controversy during the years 1947 and 1951, including several hearings by Congressional Committees.

These Congressional studies culminated in the enactment of Section 314 of the Revenue Act of 1951, 65 Stat. 491-93. This 1951 amendment provided for the taxation of cooperative organizations but permitted them certain exclusions or deductions from income including patronage distributions "whether paid in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount allocated to him." It is clear from the record of the hearings before the Committees that in enacting these provisions, Congress understood and believed that the distributions which were allowed to be excluded or deducted from the cooperative's corporate income would be taxable as income to the patrons. See for example hearings before the Committee on Finance, U.S. Senate, 82nd Congress, Revenue Act of 1951, Part 2, pp. 1250-52, 1286, 1419, 1430.

The decision in the instant case, as well as the decisions in the *Caswell* and *Carpenter* cases, are in direct conflict with the premises upon which Congress enacted this legislation. The reliance of Congress upon the established practices of Internal Revenue, in en-

ting this legislation, accentuates the wisdom of the ual rule that long standing administrative practice ll be followed by the courts in statutory construc-n. *Commissioner* v. *South Texas Co.*, 333 U.S. 6, 501.

IMPORTANCE

A decision of the pending question by this Court is public importance:

(1) To eliminate present confusion arising from the istence of at least three different rules, no one of ich can be followed by any taxpayer without in-nging the other two.

(2) To inform hundreds of thousands of farmers w they may safely report sums of this character in eir income tax returns; and

(3) To eliminate the hardship and injustice of im-sing upon many farmers, such as petitioners in this se, two taxes in a single year when only one tax ould be collected.

nfusion

The state of the law in this important field of fed-l tax administration is thoroughly confused. At st three distinct and different rules are now as-ted as to when and in what amount cooperative trons are taxable upon patronage distributions ap-ed or set-off against their capital obligations.

The Treasury Department's position is that if the pital contribution is withheld from patronage mar-ns which the Cooperative was obligated to distribute the patron, then the measure of the income to the tron is the full amount withheld, as and at the time dited and notified to the patron regardless of ether or not the credits or any issued evidence there-

of have any market value. Reg. 118, 39.22 (a)-23; Rev. Rul. 54-10 (Cum. Bull. 1954-1, p. 4) (See App. E)

The Tax Court and Court of Appeals for the 5th Circuit hold that the cooperative patron is taxable at the same time that the Treasury would tax him, but that the amount of income subject to tax is limited to the fair market value, rather than the face amount, of whatever certificate or other document may be issued to the patron as evidence of his contribution to capital. *Commissioner* v. *Carpenter,* 219 F. 2d 635; *P. Phillips* v. *Commissioner,* 17 TC 1027 (1951); *Joplin* v. *Commissioner,* 17 TC 1526 (1952); *Howey* v. *Commissioner,* TC Memo. 1954-19, Docket No. 39712.

The Court of Appeals for the 9th Circuit holds that regardless of the fair market value of the instrument issued, no income is received by the patron until and unless the capital contribution is redeemed by payment to the patron in cash. *Estate of Caswell* v. *Comr.,* 211 F. 2d 693.

If a cooperative patron seeks to follow the rule of either the 9th Circuit or the 5th Circuit, he will be subjected to an additional assessment in accordance with the Treasury Rule, and will be forced to litigate the matter, as the Treasury has not acquiesced in the decision of either Circuit. If he follows the Treasury Rule, and it is later decided that one or the other of the Circuit Court Rules is correct, he will have been subjected to payment of a tax considerably in advance of its due date. In this state of confusion it is impossible for anyone to advise a cooperative patron how he should file his return.

The Bureau of Internal Revenue has contributed much to this confusion. The Cooperative here involved had been advised by personnel of the Bureau prior to

1950 that its patrons should report the cash refunds only, and not the certificates of contribution (R. 100-101). As late as January, 1951, the Deputy Commissioner advised that only the cash, and not the certificates, was income to the patrons. Shortly thereafter he changed his counsel to conform to Income Tax Information Release No. 2 dated April 13, 1950 (App. E). See Petitioner's Exh. 38.

Numerous Taxpayers

Capital financing through a withholding of proceeds of sale or patronage dividends and their application or set-off against obligations for capital contribution is common among the agricultural cooperatives. See Hulbert, *Legal Phases of Cooperative Associations,* (Farm Credit Administration, U.S. Dept. of Agriculture, Bull. 50, 1942), p. 278. Agricultural cooperatives in the United States in 1951 were estimated at 10,166 with a membership of 7,363,129 and a net business volume of almost 9.5 billion dollars. Year Book of Agriculture, 1954 (U.S. Dept. of Agriculture), p. 247.

All farmers are not taxpayers; nor are they all members or patrons of cooperatives. But with the large membership indicated by the Department of Agriculture estimates, even though many file no tax returns, it is obvious that many hundreds of thousands of farmers are presented with this problem in filing their tax returns. Such a large and important segment of taxpayers should not be permitted to remain in the state of confusion now existing.

Hardship

In the instant case petitioners filed their 1949 return in accordance with the rule later announced by

the 9th Circuit Court of Appeals. On audit the face value of the certificates received in that year were added in accordance with the rule of Internal Revenue. However the audit did not take out the cash received which, under the Internal Revenue rule, represented a return of capital. Thus these taxpayers were subjected to a double tax in the years here involved.

Because the cash received represented refund of several prior years' contributions to capital, the result in the instant case is to put in the year 1949 the patronage payments of three years namely 1930, 1931 and 1949 and into the year 1951 patronage payments of four years, namely 1935, 1936, 1937 and 1951. This is a harsh and costly pyramiding into one year of income actually earned over several years; it is not sanctioned by the Internal Revenue laws.

Similar hardship will result to many other cooperative patrons whose tax returns may be audited by Internal Revenue. This pyramiding of the tax is the result of a policy announced for the first time by Internal Revenue in Section 4 of Rev. Rul. 54-10 (App. E). The effect of this feature of the ruling is to declare a return of capital to be income merely because the statute of limitations has run upon the collection of taxes on an item of income in a prior year. Such action is arbitrary and capricious and not in accordance with the provisions of the Internal Revenue Code.

ERROR IN DECISION

The Court of Appeals erred in its decision of the instant case.

Petitioners delivered their fruit to Apple Growers Association for marketing on a cooperative basis, that is, as the petitioners' agent. *Oregon Growers Coop.*

Assn. v. *Lentz,* 107 Or. 561 at 579, 212 Pac. 811. The patronage contract between the two expressly required the cooperative to pay petitioners the full net proceeds within a specific time. (App. D). Such payment of the net proceeds was mandatory—a legal obligation of the cooperative.

Petitioners, however, were obligated by the by-laws to contribute to the capital fund each year on the basis of the amount of their fruit handled by the cooperative (R. 29-30; Pet. Ex. 14).[5]

The cooperative in this case set off petitioners' obligation under the by-laws, as *members,* to contribute to the capital fund, against the cooperative's own obligation under the *patronage* contract to pay petitioners the full net proceeds of their fruit. See Nieman, *Multiple Contractual Aspects of Cooperatives' Bylaws,* 39 Minn. Law Rev. (Jan. 1955), 135. Each of these independent obligations of the two parties was thus fully settled and discharged as to each year's crops. *Robinson* v. *Lind,* 155 Or. 591, 65 Pac. 2d 669.

In return for the application of their money to the capital fund, petitioners received not only the benefit of the discharge of their obligation to contribute to that fund, but also received capital credits to their account on the cooperative's books. These entitled them to their prorata share of the proceeds of the cooperative's assets in event of dissolution or sale of the cooperative (Pet. Ex. 13, p. 13; R. 32).

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[5] *Davidson* v. *Apple Growers Assn.,* 159 Or. 473 at 482, 79 P. 2d 991 (1938): "... All grower members are bound by the provisions of the members' by-laws of defendant by reason of their relationship to defendant as grower members."

Petitioners thus clearly received the economic benefit of those portions of their net sales proceeds which they did not physically receive but which paid for their interest in the capital fund and satisfied their legal obligation to that fund. Such proceeds were thus income to petitioners earned and received by them in the years in which so applied. *Helvering* v. *Horst*, 311 U.S. 112; *Corliss* v. *Bowers*, 281 U.S. 376; *Burnet* v. *Wells*, 289 U.S. 670.

It is significant that the capital charge based upon the quantity of fruit handled was in no way dependent upon successful sale of such fruit. Petitioners would have been obligated for such charge even if no net proceeds had accrued from their fruit (R. 56-57, 142).

It thus necessarily follows that the cash refunds to petitioners in the years 1949 and 1951 here involved were in fact returns of capital, and not ordinary income to them in those years. *Burnet* v. *Logan*, 283 U.S. 404; *Edwards* v. *Cuba Railroad Co.*, 268 U.S. 628. For such capital they had given a consideration, through set-off of their claim for proceeds of sale, equal to the face amount of the certificate; accordingly there could be no capital gain in its redemption at face value.

CONCLUSION

For the foregoing reasons it is respectfully submitted that this petition for a writ of certiorari should be granted.

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